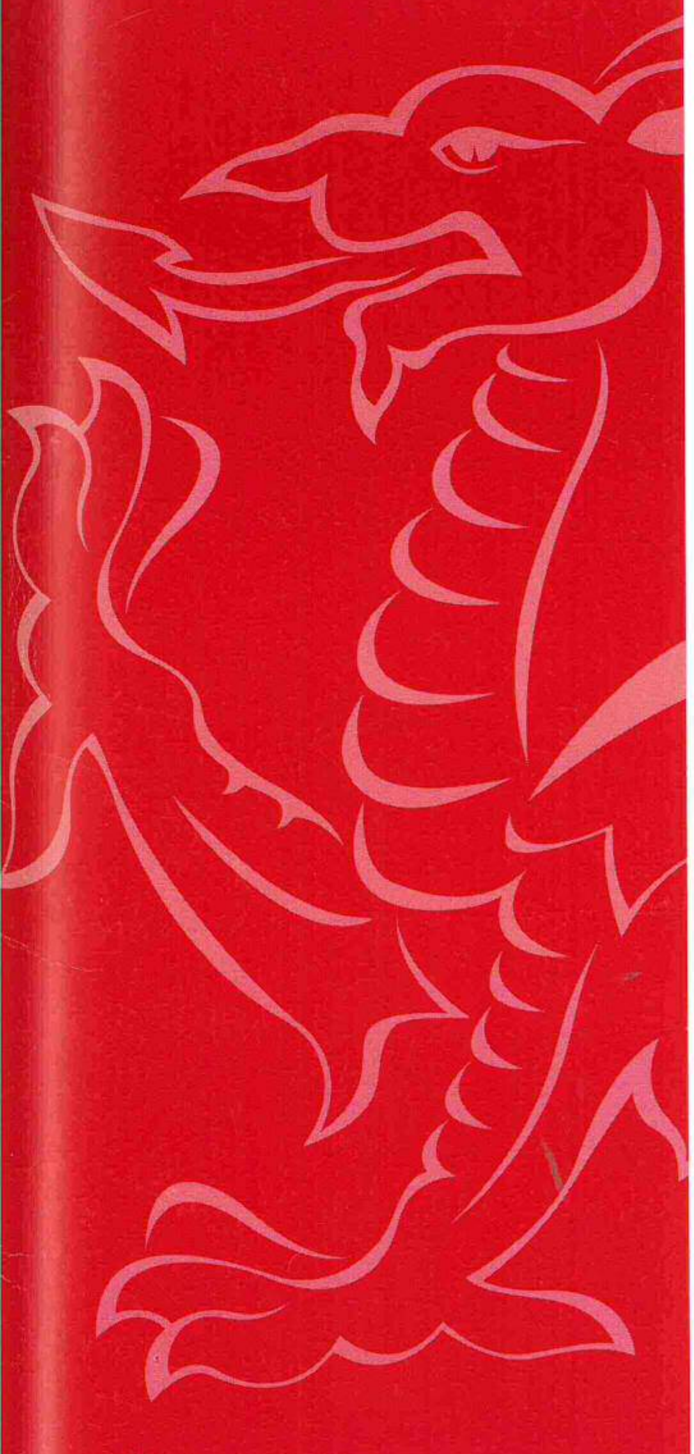

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The *Welsh Economic Review* is produced twice yearly, by the Welsh Economy Research Unit (WERU) at Cardiff Business School. The aim of the *Review* is to provide an authoritative and objective analysis of the Welsh economy in a manner that promotes understanding and informs decision-making. The 'core' section of the Review is written by members of WERU, with feature articles contributed by academics or practitioners within or outside Wales. The *Review* is circulated widely within Wales, to both private and public sector organisations, including the education sector and the National Assembly.

Notes for Contributors

Authors should send papers for potential publication in the *Welsh Economic Review* to the Editor at the address given below, preferably via e-mail in a Word for Windows format. Papers are welcome on any topic that would be of general interest to the readership, and should be written in a style suitable for non-specialist readers. Papers should be approximately 3,000-4,000 words and any graphs or figures should be accompanied by the underlying data to allow reproduction.

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Economic Commentary

The World Economy

The fight against inflation has been at the forefront of economic policy in advanced economies world-wide during recent decades. The number of central banks that have gained independence has steadily increased, contributing to a general success in defeating inflation and in maintaining policy credibility. It is widely acknowledged that the principal objective of central banks should be the pursuit of price stability. However, achieving low inflation does not itself guarantee economic and financial stability. In the USA, during the latter part of 1999, the Federal Reserve allowed a stock market bubble to develop, fuelled by rapid credit growth. The Federal Reserve's success in maintaining low inflation along with low nominal interest rates may have resulted in the rapid increase in share prices, inadvertently causing this asset price inflation.

There are a number of reasons why other central banks should also worry about asset price inflation. Firstly, asset prices are an indicator of prices for future consumption. For instance, a rise in the price of houses today will increase the cost of future housing services. Secondly, rising asset prices encourage excessive borrowing by both firms and consumers, leaving them susceptible to the fallout when the bubble eventually collapses as asset prices fall or recession occurs. Another concern is that the cost of capital becomes artificially low, so firms are tempted to over-invest in risky projects. Over the past six years American investment has leapt from 13% to 18% of GDP, similar to the surge experienced by Japan in the late 1980s. There is a danger that as the quantity of investment increases at such a rapid pace its quality deteriorates. Central banks should thus be wary of sharp rises in share prices accompanied by rapid growth in domestic demand and heavy borrowing.

Economic growth remains strong in the United States, with estimates suggesting GDP growth rates of around 4% for 1999 (National Institute for Economic and Social Research - NIESR). Despite asset price inflation, underlying price inflation has been stable, aided by above trend growth in productivity, coinciding with the lowest unemployment rate since the 1960s. However, signs of overheating are beginning to emerge, with the current account deficit projected to rise to 4% of GDP by the end of 2000. The Federal Reserve has now acted to stem the onslaught of the stock market bubble by raising Federal Fund rates. Although GDP growth slowed to 0.4% in the second quarter of 1999 from 1.1% in the previous quarter, more recent figures suggest that US growth has since picked up again - to 1.2% in the third quarter (Bank of England Quarterly Bulletin). However prospects for the US economy remain particularly dependent on future asset prices. Although equity prices have fallen from their peak levels, they still remain 10% higher than at the start of 1999 and 25% higher than two years previously. Inflationary pressures have been arrested by labour productivity growth, at around 2% per annum over the period 1996-98, and the appreciation of the dollar since 1995, with import prices having fallen by 15% over the past four years.

The Japanese economy appears to have stabilised, with output during the second half of 1999 around 1.7% above its level in the latter part of 1998. Domestic demand in Japan is currently being supported by expanding public investment, which was around 14% higher in 1999 than in 1998, and reductions in both corporate and household taxation. The recovery of other Asian economies has aided external demand in the Japanese economy. However, declining business investment and possible further falls in employment mean that the recovery is still on tenuous ground. The appreciation of the Yen over the past year will intensify the deflationary pressures in the economy. It is not yet clear how the appreciation of the Yen will depress growth. If Japanese exporters do not pass on the appreciation in their product prices it could be at the expense of profits. This could subsequently reduce growth in future investment and put downward pressure on equity prices. Even if the appreciating Yen does not reduce Japanese exports, it could cause increasing import volumes at the expense of domestic production.

A couple of years ago Thailand's currency (the Baht) was influential enough to send the Asian economies into crisis, and to concern central banks world-wide. When the Baht was floated in mid 1997, its value fell, altering investment patterns to other East Asian economies, until one by one their currencies also came under pressure. Confidence did not return until well into 1998, and slowly currencies began to recover. However, towards the latter part of 1999, the Baht once again started to fall, reaching a 13 month low in late September 1999, before recovering. The difference this time is that, unlike a year ago, Thailand's reserves have risen sharply, allowing it to stop drawing funds from the IMF rescue package. Moreover, many foreign debts have been either repaid or rescheduled. It would appear that the East Asian economies are returning to 'normal', and investors have not been alarmed by falling currencies. Only in Indonesia did panic set in when the Rupiah fell by 25% in just two months, before starting to recover. Recent currency fluctuations in South East Asia have tended to vary in timing and magnitude, in comparison to periods of high stress in the past when many of the region's currencies fell simultaneously. Recent American interest rate increases are making Asian currencies look less attractive, however most have been sliding due to particular characteristics of the individual economies.

In July 1999 the European Central Bank (ECB) announced a tightening in its policy for the Euro. On November 4th 1999 the ECB raised its key interest rate by 0.5 percentage points to 3% - the first rise since the launch of the Euro. There were several arguments for increasing interest rates. Not only is business confidence increasing due to a healthier economic climate, (partly as a result of the ECB cutting its rate by half a point in April to fend off deflation), but more importantly was the money supply growth at 5.9% - which was well above its reference rate of 4.5% per annum. The ECB worried that this could send inflation above its ceiling of 2%.

During the first half of 1999 economic growth in the EU had slowed as a result of a decline in global demand, with falling growth rates experienced in all EU countries. For example, growth was stagnant in Italy, Belgium, Germany and Denmark; yet in Sweden growth accelerated. EU Inflation began to edge upwards over the course of 1999, largely as a result of higher import prices and the weakness of the Euro, in addition to recovering commodity prices. Inflation was at 1.2% in September, up from 1% in June. However, core inflation (excluding energy, food, alcohol and tobacco) remained fairly constant during 1999 at around 1%.

In general, unemployment in the EU is on a downward trend. However, unemployment rates vary significantly between countries. For example, German unemployment rates fell from almost 10% in 1997 to 9% in 1999 (with variations between East and West Germany), whilst in France unemployment fell from 12.3% in 1996 to just over 11% by 1999. The unemployment rate in Spain was over 16% in 1999 (ILO measures, NIESR).

The UK Economy

The UK economy is estimated to have grown by around 1.8% during 1999 while inflation has remained below its target of 2.5% for a number of consecutive months. In January 2000 the Bank of England raised interest rates to 5.75% in response to a number of inflationary pressures. For example, in the labour market, there was a surge in earnings growth of 4.9% in the first three quarters of last year, boosted by rising bonuses and overtime payment. This rate of growth in earnings was higher than the Bank of England considers compatible with the government's inflation target – a rate of growth of 4.5%. In November 1999, the European Commission suggested that the interest rate gap between Britain and Europe will continue, as UK interest rates are likely to rise still further in 2000, to prevent overheating in the economy and to keep inflation under control (NIESR forecast interest rates to rise to 6.5% by the end of 2000). Another factor likely to have been scrutinised by the Bank of England's Monetary Policy Committee is the condition of the housing market. The number of housing transactions and house prices increased during 1999. Not surprisingly, net mortgage lending was at £9.3 billion in July 1999, up from £6.5 billion in the final quarter of 1998.

Even though the UK economy is growing, particularly in the service sector, and more slowly in manufacturing, there are some worrying undertones. A recent DTI report (UK Competitiveness Indicators 1999) found that the UK lags behind other advanced nations on many crucial economic indicators. For example, in terms of productivity, average GDP per employee was some 33% behind the USA. One possible reason for this is comparatively poor levels of investment. For example, patent performance in the UK is lower than in comparable economies, as is government-funded research and development per worker, which is far lower than in the USA. The DTI report showed that UK manufacturers came eighth out of eleven countries in terms of the percentage of the turnover generated by introducing new or improved products to the market.

UK manufacturing is still handicapped by the high value of sterling, which over the period 1995 to 1999 has resulted in sluggish growth for the sector compared to the economy as a whole. For example, there has been a deterioration in the balance of payments of the food sector for which the deficit has doubled from £13 billion in 1996 to around £28 billion in 1999 (NIESR forecast). There are significant differences in investment between sectors, for example, business investment outside manufacturing grew by around 12% in 1999; while manufacturing investment was expected to fall by 12% during 1999.

Unemployment in the UK, based upon latest claimant counts information for 1999 was 4.2%; it's lowest since 1980. Based upon the alternative International Labour Organisation (ILO) measure, the standardised unemployment rate (which is internationally comparable) is 5.9%; still the lowest recorded level since 1984 (Labour Force Survey). Growth in employment has been strong since the end of the early 1990s recession. However, much of the growth over the past 18 months has occurred in the service sector. Between 1994 and 1998 the manufacturing sector also experienced employment growth, although it is arguable that future growth will have to come from productivity improvements, if inflation is to be kept in check, since there is little spare capacity in the labour market. There is still scope for the long term unemployed to move into employment, with the New Deal assisting them to find work and training. Over the period June 1998 to June 1999 most job losses have been in manufacturing, conversely gains have been experienced in non-manufacturing, notably financial services. Some regions of the UK have been affected more than others, for example, the high proportion of manufacturing exporters in the Midlands have been hit by the high value of sterling, with negative impacts on employment growth. Total hours worked in the UK, vacancies, and measures of employment intentions have all picked up during 1999 (Bank of England Inflation Report), although skill shortages remain in some sectors. The Confederation of British Industry (CBI) measure of unskilled labour shortages in manufacturing, and the British Chamber of Commerce (BCC) measure of general recruiting problems, are both above their long run averages. Skill shortages are becoming increasingly common in many parts of the UK, particularly in the North, Wales and Scotland.

The Welsh Economy

The unemployment rate in Wales averaged 7.1% during the period August-October 1999, around 1 percentage point above UK levels (ILO measures). Employment prospects continue to be affected by relatively high Sterling rates, which have impacted on Welsh exporters. High Sterling rates may have had a role in the closures of the Lucas and Dewhirst factories in the Swansea valleys, and also job losses in British Steel in Port Talbot and Llanwern. By the end of 1999 some economic indicators showed improvement, for example, the unemployment claimant count in October was 61,200, down by 10% on the previous year. Evidence from the Labour Force Survey showed that Welsh employment grew by 2.3% up until the third quarter of 1999. Prospects for the service sector have been aided by developments in banking and finance – in particular call centres. In November 1999 Cybercall, an IT and communications company announced the creation of 200 jobs in Cardigan, following the construction of a new site. Also in November, the new £20 million Cable and Wireless Communications service centre opened in Swansea, employing 400 people, with this expected to increase to 1,200 by the end of 2000. As in the UK, there are disparities across sectors in the Welsh economy. For example, the ONS reported employment growth in agriculture, forestry and fishing of 10%, 11.6% in construction and 3.4% in service sectors but declining employment in manufacturing of 6% between June 1998 and 1999. The New Deal has found 12,000 jobs for people (mostly young people) who previously had little chance of finding employment. The real success of the New Deal will be if the individuals it has helped find jobs are still in employment in five or ten years time.

The UK housing market 'boom' has been mirrored in parts of Wales. House prices in Cardiff and its surrounding areas have experienced trends similar to the UK economy, whilst other Welsh areas have seen house prices increase by much smaller amounts. In September 1999, stark warnings of the Welsh poverty trap were made by the TUC in Wales, Citizens Advice Bureau and the WDA (Western Mail, 6.9.99). GDP per head is around 82% of the UK average, although there remain areas in Wales where the gap rises to 30% (i.e. 70% of UK GDP per head). A strategic objective under consideration by the WDA is to increase the position of Wales to 90% of UK GDP per head by 2010 (WDA, 1999b). However, closing the prosperity gap by this amount will require an average growth rate in the Welsh economy of over 4% per annum, (WDA, 1999a). Objective 1 status for West Wales and the Valleys could make an important difference to economic well-being in Wales, bringing a potential £1.3 billion of funding over the period 2000-2006.

According to the CBI's Industrial Trends Survey, business confidence in the economy (based upon the percentage difference between positive and negative responses to questions about confidence in the economy) rose during 1999, from −3% in the second quarter of 1999, to 23% in the third quarter. A Cardiff Chamber of Commerce survey of 450 firms also found business confidence and performances improving, during the third quarter of 1999, with growing domestic demand and exports. However, this improvement may now slow, as a result of the interest rate increases during the latter part of 1999 and early 2000.

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